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**ESSAYS IN PUBLIC FINANCE: THEORY AND
PRACTICE OF DECENTRALISATION**

by

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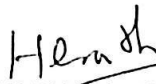
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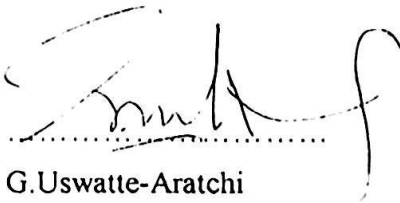
DECLARATION

I certify that this thesis does not incorporate without acknowledgement any material previously submitted for a degree or diploma in any university and to the best of my knowledge and belief it does not contain any material previously published or written or orally communicated by another except where due reference is made in the text.



.....
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To the best of my knowledge this statement is correct.



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ABSTRACT

Functioning of the government is vital in economic development. This role can be played on either centralised or decentralised basis. In recent years, due to developments in the European Union, suspicion of powerful centralised system of government, growing disenchantment with the functioning of the public sector, and cultural and ethnic diversity, decentralisation has become an attractive topic among both economists and political scientists. Thus, developed countries, developing nations and economies in transition have introduced decentralised systems of government. Sri Lanka belongs in this group.

A discussion of decentralisation of government touches on theoretical work on provision of public goods, Tiebout model, club theory, and the Leviathan model. In respect of the first, Samuelson's discussion on determining of public goods, is widely accepted. However, not all public goods (i.e. judiciary, education etc.) can be explained in terms of Samuelson's criteria. The Leviathan model explains the relationship between the degree of decentralisation and size of government. However, it discusses a situation after decentralisation and is not useful in discussing situations before decentralisation. The Tiebout model can be explained in terms of club theory. Consequently, club theory was selected to analyse the provision of public goods in this study. In the theoretical part of the study, first, Samuelson's case is reviewed and modified. Secondly, after reviewing the literature on club theory, that theory is presented with some modifications and new applications.

These modifications of the club theory, include how club theory is used to analyse both 'representation of individuals' in their collective behaviour and 'social groups'. When social groups incur a new kind of transaction cost, namely security expenditure, a new formulation can be made with respect to social groups. In addition, the way club size is affected as a result of increase in consumer's income is presented in a new manner.

Club theory has not been sufficiently improved to embrace the supply-side efficiency of the club. To fill this gap, the theory is applied to explain centralisation within decentralisation. In provision of some public goods, when consumers have to bear a transportation cost to reach the service centre, club theory violates its assumption that clubs are serving flying consumers. On such occasions, the way of establishing public service outlets is mathematically worked out.



Not all economists accept decentralisation as desirable. They argue that decentralised systems are not more efficient than centralised ones. However, empirical studies on this issue are scarce and the hypothesis cannot be tested against evidence. In order to fill this gap partially, an empirical study was conducted with respect to the Provincial Council system introduced in 1987 in Sri Lanka

The empirical study consisted of two components, namely overall economic features and performances and school education. The study of the first component, consisted of descriptive analysis for the post decentralised period in light of quantitative data. The second component of the empirical analysis assessed the efficiency of school education under Provincial Councils, since education is a widespread public good of the country. Constraints on both theoretical and empirical analyses are very strong. On the issues in both areas, there is a dearth of reading material in Sri Lanka. Further, decentralisation remains little studied by economists.

The conclusions reached in the study are the following. Samuelson's criteria for the determination of public goods have been improved and modified in this study. Club theory has been used in the analysis of decentralisation. It was used to explain 'representation by individuals', and social groups. The theory can also be used to explain a reason for decentralisation, since there is a negative relationship between consumer incomes and club size. Mathematical presentation of the distribution of service outlets demonstrated that a decentralised system is more efficient. There is no uniformly accepted definition of decentralisation among economists. Definitions vary from country to country and from person to person. Of all the functions of government, allocation, distribution and some elements of the constitution (judiciary) can be decentralised while others cannot.

Even though decentralisation was introduced by the Provincial Councils Act 42 of 1987, the degree of decentralisation is very limited and the country still remains as a unitary state. However, there is high degree of decentralisation in education. Over 50 percent of its work was reported to have been decentralised. After decentralisation, the output of school education has quantitatively increased at provincial level, but efficiency has not. Even if the overall economy has grown considerably after the introduction of Provincial Councils, regional economies have not grown satisfactorily. Therefore, Provincial Councils have failed to ensure same balanced regional growth. There is no evidence to assess that the degree of decentralisation has made positive contributions on economic growth. Provincial

Councils have some decision-making powers in respect of generating alternative income sources and expenditure activities. Yet there are no electoral cycles to be seen in this country. In the proposed package for the devolution of power the country is considered to be a union of regions, where legislative, judicial and executive powers of government, will be devolved increasing the degree of decentralisation. After implementation of these proposals, further studies will be required to appraise the relationship between decentralisation and economic growth.

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CHAPTER ONE

BASIC ISSUES AND PRESENTATION OF THE STUDY

1.0 Introduction

This dissertation examines the need for government, some considerations of efficiency in the provision of government services, decentralisation in particular, and the consequences of some of those considerations on the economy in Sri Lanka. It deals with concepts and theories and their application in the real world. This chapter is devoted to discuss basic issues such as government intervention in economic activities and the theoretical framework in terms of which decentralisation can be analysed, as these are very important in building up the hypotheses that are expected to be tested in the study.

1.1 Market failures

With the hindsight of development experience in many countries, it is evident that the speed of development and growth of welfare are higher in economies with market-friendly policies. The market permits goods and services to be allocated to uses in which they give the highest value. The market system functions as if an invisible hand were guiding resources to their most highly valued uses to ensure that consumers get the goods and services they want and are able to pay for. The market ensures higher welfare levels, in the perspective of Musgrave (1959), however, without government, market is likely to malfunction in three ways. First, even though the market system were to operate at full employment level and were to direct all resources into their most efficient uses, it does not ensure an equitable or a desirable distribution of income. Therefore, without government, no market leads to optimum welfare. Secondly, as was explained by Keynes, in a market economy, the aggregate spending in the private sector will not generally ensure full employment with stable prices. Therefore, without government, the economy will function below its potential. Thirdly, in unfettered markets some misallocations of resources among alternative goods and services are possible. In some instances monopoly appears, in some others the market fails entirely in the presence of externalities, imperfect competition, inadequate information (Stiglitz 1995:35), non-excludability (Musgrave and Musgrave 1976), time lag, and high transaction costs (Stevens 1993:59-68) while in others, it can function only in an inefficient way. Market failure provides a rationale for government